IFB364: P/E Ratios, Value Traps, and Market Analysis

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**00:00:00 Dave:** All right, folks. Welcome to Investing for Beginners podcast. Today we have episode 364. Today we got a bunch of great listener questions. We are going to go ahead and read and answer. So let's go and dive on into those. So hello, I have be folks. I love your podcast and thank you for offering this amazing service.

**00:00:51 Dave:** I currently care for a 100% disabled veteran and receive a stipend from the VA for this. My stipend is not taxed. If I open an IRA or invest in an index. When I take my money out when I'm 65 ish, will I pay taxes on the money that was used from these untaxed stipends? I'm brand new and we'll be putting skin in the game tomorrow. It's a very special day and a long time coming. Warm regards Sabrina. So Andrew, what are your thoughts on Sabrina? It's great question.

**00:01:19 Andrew:** Well, First off, it's great that you're putting skin in the game. Congrats. That's an exciting time and thank you for listening so. From what I saw on the Internet on Google, it looks like you cannot put. You have to have earned income in order to contribute to an IRA. Whether that's a Traditional IRA or a Roth IRA. And so if that is your only income, my understanding is that you would not be able to contribute if that's your only income. I did see Morningstar has a blog that said if your spouse has income, you can contribute to an IRA, but I don't know if that specifically applies to this or not, and so for me, like I would rather be safe than sorry and and not put that money in, but it looks like there can be different exclusions, perhaps or or different applications of this, so it's it's a little more complex than just saying yes or no.

**00:02:27 Dave:** Yeah, my recommendation would be to talk to a tax professional, talk to somebody. You can even just call up HR block and say the exact same thing you just told us. This, and they would be able to give you direction on whether you could do this or not and how it would be taxed at the end. To Andrew's point, I think it's better to be safe than sorry than just to try to do something and then find out later that this
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is not possible. So that would be my recommendation, specially because you've earned it. And it's something that you should make sure that you're as careful with it as you possibly can. So I mean we, we thank you for your service and for everything that you're doing with that, but it needs, I would be probably more margin of safety conscious with this than anything else. That's how I'd approach it anyway. Yeah, totally. Alright. So hopefully we that helps Sabrina and let's move on to the next question. So here we go. Hi there. Thanks so much for the great podcast. It's one of my favorites and I learned so much. I have a question about retirement options for air quote, higher earners. I put that in quotes because while I'm in a higher tax bracket, we live in a city with a high cost of living, so it doesn't always feel that. I am currently maxing out my 401K at work and my ma GI means I can no longer contribute to my Roth IRA with my employer offering a retirement plan. I also earn too much to make tax deductible contributions to a Traditional IRA, so I'm at a little loss about the best place to invest for retirement. Do I just make non deductible to contributions to a Traditional IRA and with them there do a backdoor Roth conversion each year, with seems complicated. Or just focus on growing wealth in a taxable brokerage account and accept taxes as part of life. Thanks for any guidance that you can share. So great question, lots of detail in here. So what are your initial thoughts.

00:04:18 Andrew: My initial thoughts is it's hard because taxes can change from year to year. And so from everything I've seen, the backdoor Roth is still an option floating around, but we're also in an election year, so we know what's going to be possible next year. I'm not sure, and that can make it hard and so probably a financial advisor in this case would be a better thing to look at, not only because of someone's personal situation, but also from the fact that tax code can change from year to year and so you know the excuse I've been doing this for 5-6 years because I heard heard on a podcast. I don't know how that would fly and that's why I would. I would want, you know, backing from from a financial advisor or like you were saying, they have a tax professional.

00:05:07 Dave: Can you imagine going to the IRS and saying but I heard it on a podcast like five years ago. Not. I'm thinking that's not gonna go over so great. Like you might get a chuckle or two. But like, actually getting away with it, that probably wouldn't fly.

00:05:15 Dave: Right.

00:05:26 Dave: I think you know again, if I was in this situation, one of the big ways that advisors can help you is specifically in the area of taxes. And it's an area that is very complicated and it can be very convoluted, and there's lots of moving parts, especially in the question. There's lots of moving parts on how and what they want to invest in, and so to make sure that your or a paying taxes cause you have to, but

also B that you are saving as much money on them as you can in any way that's legally possible, I would encourage everybody to to look at doing that, because I think that puts you in a better situation. Any money that you can save on that end can compound over a longer period of time and and be a great wealth better. But it's also complicated and this is definitely not Andrew and I's expertise. And so I would strongly encourage you to reach out to somebody. I know it sucks to pay for that, but there are lots of great services out there now. Our our friend named Jeremy created this resource called Tangerine, where they have advisors now that you can use via online, that is a one time charge and this would be a perfect situation for something like that where you just approach this person and you can find other local ones that will do it for on a fee basis, like a one time thing and just present what you're talking to us about with numbers and then they can get back to you on the best course of option for you and then you know it may cost you a couple 2-3 hundred bucks, but I think that's well worth it if it puts you on the right track. So that's that's that would be my guidance. That's what I would do if I was in that situation so that that I guess that's my thought.

00:07:10 Andrew: Yeah, that's a good problem to have.

00:07:11 Dave: Yeah, very good problem to have we we would all like that wouldn't we? Alright, so let's move on to the next question. So this one is hi Dave and Andrew. My name is Matt and I started following you all not that long ago. I've listened to a ton of podcasts already and have the free ebook and value trap Indicator 3rd edition. I have learned so much recently. I just started My Portfolio about a month ago now, following all the ratios that are listed throughout the Books Slash Podcast. I am currently using fidelity as my broker and they list out almost all the ratios except DDE or debt to equity. I can't find a D to E ratio anywhere. They do however have a section of debt that has a bunch of percentages rather than a standard number. Can you tell me what percentage I should be looking for here instead of trying to find different websites for ad slash the ratio. This is an example of a stock with the percentages unlisted. So he listed 1 below. The numbers are terrible, they are terrible. This one uses an example and you would appreciate us kind of looking through this and giving him some guidance on what numbers he should look for, particularly with the debt debt to equity ratio. Easy for me to say so this is again great question for Matt. Andrew, do you want to kind of take first stab at how we can help him with the debt to equity rate?

00:08:24 Andrew: So yeah, for sure. So the overarching goal of the debt to equity ratio is you're trying to determine as a company have too much debt? Is that going to become a problem for them and that can hurt the stock in the longer term for several factors. 1 You know if if that's too high and you have high interest, that's less profit that the company makes year after year after year. And then secondly, as a shareholder, you're just entitled to less of the free cash flow. So after the profits, the company can choose what they want to do with the money and if they have a bunch of debt to pay off, that's money. That's not going to share buybacks or dividends. And so again, too much debt that a company is not going to be able

to refinance can be an issue and that's why that's equity can be one of the ways a nice quick shortcut that you can see if a company doesn't have too much debt and that can be part of your filtering process, so that's kind of the beginner one O 1 viewpoint of why DE or debt equity kind of matters. In this case, you know for you, Dave, because Matt's talking about not being able to find the DTE ratio anywhere. What's the practical solution to that? And thank you for writing it, Matt. It's so great to to hear all the things you have to say about about the show, so.

00:09:49 Andrew: What's the best way to steward your wealth looking to find great businesses with a margin of safety? My advice? Value spotlight@valuespotlight.com. Well, yeah. What are your thoughts on that?

00:10:02 Dave: Yeah, I mean it's it's a great question and the I'm not. I can't speak directly to fidelity, even though I use them as a brokerage. I don't, frankly use their research tools at all. I don't even know if I would know where to find them, but I know that our friend Brayden at Finch at I/O has all those ratios available and for free that would be one way. The other way to do it is to calculate it yourself. So to look at the financial statements and it it's fairly easy ratio to calculate you need the total debt for the company and you can find that in two main place. You can find that in the current liabilities and you can find it in the long term liabilities. It will be listed as short term debt and long term debt. You add those numbers up and then you compare that to the shareholders equity and that's how you calculate the ratio. So there's other things if you want to really get into the nitty gritty, you can add leases and other things. But just for ease of working with beginners. It would be better to just start with the long term and short term debt. Add those numbers up, compare them to shareholders equity and see what your ratio comes back at. That's how I would do it and that's how I I did it before I discovered the joys of these financial websites. But I think that's the easiest way to do it and frankly not always are the numbers you see in the financial websites exactly true, and you know they'll be within a range most of the time, but that's that's the easiest way. That's the way I would do it is go back and look at that. What are your thoughts on that?

00:11:37 Andrew: Yeah, I agree. So if you're a beginner, I do pull up that balance sheet. What what's the best way to do that easily the best way is to go to sec.gov or you can go to the company website and they will have financials on there as well and you just look for the balance sheet for the latest year and annual. Which is in in the 10K and then you just look up the numbers that will be in the balance sheet. You can use control F to find the balance sheet or you can use the hyperlinks. A lot of companies now have hyperlinks. If you kind of scroll past the first, you know page of the 10K, they'll have links to all the different sections and it's in section 8 and that's where you'll find all the financial numbers, and so you can either click on the hyperlink, Scroll down to the balance sheet, or control F and you can find the numbers that way, and it's it's fairly easy, and it's a quicker. It's a quick way to to get the answer that you're looking for.

00:12:37 Andrew: Yep 100%.

00:12:39 Dave: What would be a good range like the company is showing us have kind of ugly numbers, but if you were looking at a company, what would be a range that you'd be like? OK, this is OK. I can dig into it, but it's not like a hard pass.

00:12:54 Andrew: Yeah, this comes with the caveat of if a if a business is more asset intensive, meaning they reinvest through their balance sheet. So if we're making that assumption at the top, then anything below one is usually pretty good. So what that's telling you is there's plenty of excess assets, if you will, to cover the debt if they needed to cover it, that's basically I would probably keep it as simple as that because if you want to get into the weeds of you know, what's a .2 versus a .3, well, I like the .2 better. I get the allure to it and it does feel nice the beginner to to look at numbers in that way, but it's really we have to remember the whole premise of the debt to equity ratio is just try to find and in the process of trying to find companies that don't have too much debt, you're also filtering against companies that maybe have too much. And so I haven't seen companies outperform other ones just because they had lower debt or higher debt. It's usually a different or multiple other factors, but it is a seductive way to analyze the company and you know I'm guilty of of trying to do that in the past and so. So that would be like the warning caveat to go along with all the the ratio talk. Is there any number that would be too high that you would be like, OK, I'm out.

00:14:31 Andrew: I wouldn't say too high where you're out, but high enough where you're like. OK, let me dig in deeper to this. So I'll have a harder, faster roll for that either, but you can you could start that one and then go up from there. Right to me, it's like any look at the balance sheet is a good look like we need excuses to look at at these things like come on, let's just do it anyway. That's the way I see it. But I get it like it's not super appealing.

00:15:00 Andrew: The higher from 1 you go, probably the more it probably needs a look right, say.

00:15:06 Dave: So let's give them a little bonus. So if there were a couple of other things that are related to debt that you would, so you look at the debt equity and it's, you know, it's nothing alarming. What else would you look at in relation to that to kind of give you a sense of maybe how impactful the debt could or could not be?

00:15:27 Andrew: Yeah, it's a great question. So something you could you could scroll up or I guess down depending on the company to the income statement and you can look for net interest you can look for interest expense and that's usually going to be below operating income. And what you want to do is compare that to the operating income and the higher the number of operating income versus the interest expense, the better. And so a company like Cummins is is one I've owned in the past and they have a higher debt to equity ratio, but it's not troublesome if I remember correctly, because they staggered the debt and so they're able to keep the interest low because the debt is staggered versus being all bunched up all at once, and so if the interest payments are low, you're generally not going to have too much of an issue with the principal and that can play a big role too. So that would be the two. The two things I would say, look at the interest and then also look at how it's maturing and if there's a big balloon payment that could be a reason to be worried about it. And so to find the second part is you can go to the notes to the financials. So if you're still in the annual report, you're in that 10K that Dave was explaining you could I like to control F for debt? It's usually no number low 789-1011 depending on the company you look for. The section that has the debt and then they will tell you when that debt is due so you can see exactly how much debt is due and and then compare that to how much free cash flow do they make every year and is it? Does it bother you or is it fine?

00:17:12 Dave: Perfect. I mean it, it doesn't bother me. It's fine. Yeah. Yeah. No, I don't.

00:17:18 Andrew: Yeah, good joke. Yeah.

00:17:20 Dave: No, I think that's the that's that's exactly right, because you're starting with like a simple premise. Then you're doing digging a little bit deeper to see you know the company most companies carry some debt and you you can see what impact that has on the cash flows via the income statement and then you know for extra credit you can use the control F function and go to the notes section and you can dig a little deeper in there and see what the maturities are, see what the interest rates are that they're paying and some of those things and and that can give you a really, really good insight into the impact of debt. And I think we need to remember that companies can use debt judiciously and well to grow. So it's not sometimes it gets the connotation, especially for new investors, and I was guilty of this many years ago that it's it's all evil and it's not. And there's nuance to it. And so as you gain more experience in investing, you'll you'll discover that. And that's one of the ways is, is that when companies are trying to grow, they can use that to grow. And especially when interest rates are low, like they were quite a few years ago. That's why there was explosion in in debt issuance because companies could borrow for you know, pennies on the dollar, literally. And they could use that money to reinvest in the company and that's why you saw have seen quite a bit of growth from companies that were able to do that well. And that's also where, I guess, for extra bonus credit where credit ratings come into play. So companies like Berkshire Hathaway, Apple,

Microsoft, some of these companies that have AAA to AA ratings can really get when interest rates are low, they can take advantage of their credit strength and borrow money to help grow the companies. And so that's a little more advanced stuff, but it's definitely something to keep on your radar. And it's it's also kind of a good cheat code if you want to see how strong the companies financials are is go to moodys.com and type in the ticker and it's for free. And they will give you a credit score. And if the company has ever borrowed money, and that's a kind of a cheat code to go OK, hey, it's actually a strong company or a, it's me. OK, maybe this definitely bears some looking into so anyway. Some additional thoughts.

00:19:42 Speaker 5: What's the biggest problem most investors face? Valuing a company with DCF. Demystify. You can start valuing a company in seven days for free. Discover the six step process for valuing companies. Unravel the mystery of valuing Google, Microsoft. Meta, NVIDIA and more go to dcf123.com to get your first lesson. Now that's DCF 123.com.

00:20:12 Andrew: I'll be down it one more time, if you don't mind. So look at it in two ways. And one way. Charlie Munger says Charlie Munger is a Warren Buffett. Basically, you don't want to have to depend on the kindness of strangers. And so when you have a company that has way too much debt or it's ballooning what tends to happen is the bond market tends to freeze up when you most need it, and so if you're relying on refinancing as a company, if you're relying on refinancing, you can freeze up when you when you need it most, and that can be a problem. Flip side of the coin is you mentioned using debt to grow. You think about a debt payments usually fixed. But if you can, let's say, buy another business that grows year after year after year, those are cash flows that they're growing on, debt that is fixed. That's where a lot of value can be created as well again depending on the interest rate all part of the nuance of doing some analyzing of a company, some some fundamental analysis as well as kind of understanding how the companies can use those tools to try to better themselves. So it's all, it's all good stuff and all part of the things that Andrew does in the value spotlight. So let's move on to the next question. So hi, Dave and Andrew. Thank you for the e-mail below. This is very helpful. I picked up fractions of this into one of your podcasts and tried to take notes while cycling on my bike. Obviously, I didn't capture everything good.

00:21:20 Andrew: Yeah, totally.

00:21:40 Dave: I'm glad your e-mail just filled in the missing blanks. Thanks again for the fantastic podcast and all the info you shared. It helps me a lot with my stock analysis so he has a question for the podcast. Could you give an example of what number the following ratio should BI use Interactive Brokers where the ratios are summarized nicely, so I don't need to calculate them them myself, but I'm not sure which numbers to look for. I picked up in one of your podcasts. the PE should be 15 or less. What about the

others, Maggie? She lists a whole bunch of of different ratios, so we'll just kind of work through them. So PE 15 more or less is ideal. What are your thoughts on that? Is that too low? Too high? Just about right?

00:22:20 Andrew: I think it's too low because it's hard to find that and it it really depends on interest rates and how bullish or bearish the market is. You have to be careful about using the past to extrapolate the future and so you know after five years of like let's say a sideways market might be a lot easier to find 15 P/E stocks, but five years after a strong bull market, it won't be as easy. So you do have to be careful about that number. And so I think 15. 15 in today's market is too low. I think you'll find too many value traps there.

00:22:57 Dave: Yep, I know this is the number that Warren Buffett. He hasn't said that, but a lot of people have deduced this from what he's paid for companies in the past. The trap that you have to make sure you don't fall into is he's playing a different game than most of us. Number one, he's waiting and waiting and waiting and waiting to buy. He also because of the size that he's dealing with, he has a lot fewer targets to invest in that we do, you know, he's managing hundreds of billions of dollars. We're imagining thousands. And so our choices of companies to buy is much, much greater. Where his is, I think I read recently is he's probably realistically has a target range of maybe 50 to 75 companies and that's it. And so he has to really to move the needle he has to buy them at a certain price to make any sort of impact. So I know where that number is coming from. And I I agree with Andrew. I think a higher number is more rational and reasonable. It also gives you a better opportunity to find companies that are less likely to be value traps like Andrew was saying, so that those are my thoughts. Let's move on to price to book and this is the P/B ratio. So this is basically the price per share divided by the book value per share, which is also the shareholders equity. So you just divide that by the share count and you get a per share value and you just compare those and that's how you get that ratio. So what would be a good price to book ratio do you think?

00:24:36 Andrew: Yeah. So I'm going to say this is also one of those lessons. I think it's pretty close to useless now. And the reason why I say that and I something I wish I learned sooner as I started to pick stocks is the higher the return on equity the higher the price to book is going to be. Because we're talking about the same thing, return on shareholders equity price to book value which is price to shareholders equity. So if a company can make more profits from the same shareholders equity they're going to have a higher price to buck unless their PE is like a2. So that makes it really, really hard. If I was looking at like a bank or something that's more asset focused or a price to book might be more appropriate. Think

something below 1 would be pretty attractive. Something below 1.5 is still interesting to me, those are my thoughts on your thoughts on PBS.

00:25:40 Dave: I would say the same. And the reason why a lot of it has changed is because the way companies invest has is changing. And I'll give you a kind of a a brief example Microsoft has a very strong balance sheet. They're one of the few companies that is a AAA rated company and they unquestionably Googles of financial strength when you look at how they actually invest to grow, it's through the income statement and that doesn't always show up on the balance sheet. And so when you're looking at the price to book, it doesn't really reflect the strength of Microsoft, because they're investing through R&D, for example, they're spending a lot of money on research and development for the cloud and all the other things that they're working in that that includes software developments. It also includes intangibles like the the brains of the engineers that work for them, that are creating all these great things and that stuff. It doesn't translate to the balance sheet. And so when you're looking at a company like Microsoft, it's harder to analyze them with the balance sheet in mind because the investments that you see there aren't really where the investments are coming from and they're really coming from the income statement. And so when I look at a company like that to me, the price of the book is not relevant. If I look at Wells Fargo or Bank of America, then I feel like it's more relevant, and so I would really only use the price to book in a bank or an insurance company, or maybe some sort of very asset heavy of of business where it may, it may be possible that it's it's relevant, but to me it's very limited to just those two sectors and that's really the only places that I use them and and to echo Andrew's numbers 1 1/2 and less is like OK, this is something interesting. If it's above that then yeah, OK, maybe not. But that's that's kind of how I try to look at it. Yep. All right. So let's move on to the next one. So this one is price to sales and this is the P/S ratio. So again, price per share divided by sales per share or revenue per share. So that's really kind of how you calculate it. What are your thoughts on the the price to sales ratio?

00:27:57 Andrew: In the same way that the price to book is affected by returns price to sales is affected by margins. So if you have a company that has 80% margins like a software company by definition their sales are smaller because they have high profit margins. So they're going to have a really high price of sales, so again struggle with using this as a a broad base. Now if you are trying to buy, let's say you're trying to buy 100 companies in a year and then you're trying, you know, you're buying all the low PB, all the low, PS, all the low PE's, and then you're going to turn around and sell them within the next 12 months, then these metrics can be a great tool because statistically, you'll find companies that maybe their profit margins are down temporarily? Or maybe maybe they're just cyclical. They're going to get a rebound soon. Those are really where these ratios can be very helpful. If you're playing that high turnover kind of deep value type of game. But if you're looking for something to hold for a longer time price to sales doesn't I mean, for me it doesn't do much anymore because I'm looking to find something that compound for

10/15/20 years and the price of sales could be high if the margin, if it's a high margin business or it could be low if it's like Costco or the operating margins like 3%, so it really again just depends.

00:29:38 Dave: Yeah. As with most finance, it depends.

00:29:42 Andrew: Yeah, I mean frustrating, right? But Right.

00:29:44 Dave: But it it's true and that's that's what makes it. That's what makes it a challenge is that there is no hard and fast rules per se. And it also depends on what kind of game you're trying to play like? To me, the price to sales ratio would probably be more effective. And I know is used far more in companies that are a not profitable or B new to the markets IPO recently companies that are unprofitable, you can't use price to earnings in a situation like that because they don't have any. So then you have to the next available place to look is something like price to sales. And that's the thing that's growing. And so that's the thing that people can use to try to judge whether this brand new company is cheaper than the other brand new company, but that's not a game I play. And so to me, I just, I don't really find price to sales useful much at all. I remember back in the day, I think it was less than 10 was what I would look for, but I don't, I don't use that. I don't use it up at all anymore. More.

00:30:54 Andrew: Yeah, I think out of all of these, PE is probably the most useful because you could use it whether you're talking about buying a basket of cheap stocks or you're buying one good compounder. Right. P is is still helpful? Yes, and it's more so for me the way the way I would use it as a shortcut would be how is it in relation to the PE of the market. So if alphabets at a 20 PE right now but the S&P 500 out of 27 alphabet might look cheap right now. And and so that's like a quick and easy way to to determine that and then understanding that super low PE stocks, a lot of them can be cyclical, which means that E part the earnings might not be dependable year after year after year and that's why it's cheaper. But I've also found some of my best stock picks in that in that area too. So I wouldn't just throw the baby out with the bath water. But those are all those are all ways that I would try to look at the ratios and I know that's frustrating because it's a great learning tool to look at PBS or look at PS and start to dissect the financial statements in that way, but I also don't want to lead lead somebody down the rabbit hole. That would not be fruitful if it doesn't fit what you're trying to do with your investing style.

00:32:17 Dave: Right. Yep, I agree. I agree. All right, folks. Well with that, we will go ahead and wrap up our conversation for today. I wanted to thank everybody for taking the time to send us those fantastic questions. Please keep them coming. If you have any questions you would like to us to answer on the air, please send them to newsletter@einvestingforbeginners.com. That is in the show notes. You can also send

them to us on the Twitter machine. Andrew and I are both on there or ex and you can also send them to us at and the Spotify app. So if you listen to the show on Spotify, you can ask US questions there. So with that, we'll go ahead and wrap us up. You guys have a week and remember to invest with a margin of safety emphasis on the safety. Have a great week and we'll talk to you next week.
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